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Draft - FCIC memo of staff interview with Dan Mudd, Fannie Mae

Daniel Mudd

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MEMORANDUM FOR THE RECORD

Event: Interview with Daniel H. Mudd, former CEO of Fannie Mae

Type of Event: Group Interview

Date of Event: March 26, 2010, 9:30-2:30 p.m.

Team Leader: Chris Seefer

Location: Paul Hastings, 875 15th Street, N.W., Washington, DC 20005

Participants - Non-Commission:

- Daniel Mudd
- James D. Wareham, Paul Hastings
- Carolyn E. Morris, Paul Hastings
- Jeffrey Kilduff, O'Melveny & Myers (Fannie Mae outside counsel)

Participants - Commission: Chris Seefer, Tom Stanton, Clara Morain

MFR Prepared by: Clara Morain

Date of MFR: March 28, 2010

Summary of the Interview or Submission:

This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted as such.

Chris Seefer opened the meeting by summarizing the mandate of the Financial Crisis Inquiry Commission, noting specifically its statutory requirement to look into the GSEs' role in the financial crisis. He thanked Mr. Mudd for his time and then asked him to briefly describe his professional background.

Mr. Mudd's Professional Background

Mr. Mudd received his Bachelor of Arts degree from the University of Virginia in 1980 and then served for the four years as an officer in the U.S. Marine Corps. He attended the Kennedy School from 1984-1986 and worked summers at the World Bank. Mr. Mudd began his corporate career at Ayers Whitmore, then moved to Xerox where he worked on an assignment to divest the company of certain of its financial services businesses. Following his work at Xerox, Mr. Mudd worked in Germany during reunification in the defense and finance ministries. He then worked at GE Capital, first as a Vice President, and later as General Manager of the Company's international equity group.

Mr. Mudd joined Fannie Mae in February of 2000 as Vice Chairman and Chief Operating Officer. In that role, he was responsible for the single family origination business, which included responsibility for setting underwriting standards and eligibility requirements. Mr. Mudd said that over time, he also became responsible for the Housing and Community Development ("HCD") division. He explained that the structure of Fannie Mae's business was essentially the same as it is today, although what Fannie Mae now calls the Capital Markets division was then called the portfolio business. Mr. Mudd said that in late 2004, he was asked if he was willing to serve as Fannie Mae's interim CEO until a permanent person could be identified. He said Fannie Mae asked him to stay on as interim CEO to complete the restatement, and in that process he was named CEO. He continued to hold that position until September 2008.

Mr. Mudd said that he did not purchase loans or securities on balance sheet at the time he was Vice Chair and COO. He also said that some assets on the balance sheet at that time were Fannie Mae MBS, but that he did not deal with those transactions specifically. He said that his group managed credit exposure without respect to who held the MBS, and that all purchase decisions were made by the portfolio business. Chris Seefer asked how Fannie Mae set its underwriting standards at that time, and Mr. Mudd said that there were a number of process steps involved in setting standards, including qualification of the customer to do business, development of product criteria, and defining pricing parameters. He said that the Company used Desktop Underwriter throughout his tenure at the Company.

<u>Fannie Mae's Shift in Business Strategy</u>

Chris asked if there were changes to the types of products Fannie Mae purchased from 2000-2004, and Mr. Mudd said that in response to changes in the marketplace, there were constant changes in the types of products Fannie Mae purchased and guaranteed. Chris said that the documents show that in the 2005 timeframe, the Company made a conscious decision to increase its purchases of non-traditional mortgage ("NTM") products. Mr. Mudd said, "I view it as a continuation of projects we were already focused in, but with a greater focus on participating in [those product lines]." Mr. Mudd said that there were many products that Fannie Mae offered, and that "in the course of 2005 timeframe, one of the most significant things happening in the market was that customers were looking for an execution that was specifically designed to go away from Fannie Mae or around Fannie Mae, and we faced a debate about whether to participate in those products or not." Mr. Mudd said that the products designed to "go away from Fannie Mae" included Alt-A, subprime, interest-only, and other "affordability products." "There was a real explosion in the marketplace of new product types," he said.

Tom Stanton asked how Fannie Mae defined Alt-A, and Mr. Mudd said, “Alt-A’s derivation was as an alternative to an A loan. So for one reason or another, there was some attribute or characteristic or feature not typical to an A loan. Subprime typically refers to the borrower having a credit blemish.”

Chris asked if Fannie Mae participated in those products before 2005, and Mr. Mudd said that it did participate in those products, going back before his time at the Company. “They were in the earlier part of that decade a pretty minor feature on the landscape, and at that point the big distinction was arm loans versus fixed-rate loans. As the decade developed, there was a burgeoning of new product types,” he said.

Chris asked when Fannie Mae decided to increase its participation in NTM products, and Mr. Mudd responded that the decision was “part of a continuum of ‘this is where we are versus the market, the market is doing substantially more of this product than we’re doing, what’s the gap, what’s the reason, what’s behind it. If we were to enter, how do we do it.’ So it wouldn’t be atypical for one of those products to start off with a process where you evaluate the product and through the portfolio you have the possibility of buying some loans, which gives access to the data, and if you like it, then you then have opportunity to buy whole loans and might subsequently offer the product to lender customers.” Mr. Mudd said that the continuum started in the mid-1990s for some of the products.

Chris referenced Tom Lund’s June 2005 “Strategic Crossroads PowerPoint,” and Mr. Mudd said that he remembered the document. He said, “I didn’t want to convey the impression that there was no debate, then sudden debate, and then a change in direction. There was a process along the way, there was a small but building volume [of NTM products]. And at that time, the market made it a question of ‘where do we go from here’ – do we participate or hold back from the market. We were also in the process of coming out of the restatement and a period where the Company had been criticized for being arrogant, for not listening to market. And we’re hearing from customers that we were still doing that. ‘The market is with these new product sets and you’re not doing your role as a provider of liquidity in the market,’” he said.

Tom Stanton asked if Charles Prince presented Project Phineus to Fannie Mae’s Board of Directors, and Mr. Mudd said no. “There was a team from Citi’s corporate finance and business [group], and there were presentations along the way. There was a component presented to the Board which Mr. Prince attended,” Mr. Mudd said.

Tom Stanton asked what conclusions Mr. Mudd drew from Project Phineus, and Mr. Mudd responded that, “the fundamental question was, does privatization make sense, does giving up the charter make sense. That was a topic looked at periodically through the years. So fundamental to that question was, ‘what is the value of the charter?’ The conclusion was that value of the charter in its first instance was that it had no more value than any piece of paper [that lets you do business]. But with the charter as a starting point over a period of years or decades, the Company had built capabilities and systems and marketing and a brand and customer relationships to fulfill charter, and a set of skills and responsibilities that represented that value. So the question became, 'if you want to change, or turn in, or change, or sell the charter writ large, then what would you do? What business would you be in? At that moment, there wasn't a business as attractive in terms of applying the skills and experience of the Company."

Tom Stanton asked if Phineus talked about the attractiveness of following the market. Mr. Mudd said, "there was a component of analysis that asked if there were additional businesses that Company was not participating in that would allow Fannie Mae to continue to operate within the charter, and that includes product that we'd have to price higher and that hadn't traditionally been part of the book at Fannie Mae." He said that the "fundamental tagline on Project Phineus was, 'does it make sense to privatize and turn in the charter?' My impression was that there were additional areas of the market that Fannie Mae was not in but were within the charter at that time."

Chris asked if during discussions of the value of the charter the Company and its consultants talked about the cost of funding. Mr. Mudd said it was, and that "[the cost of funds] was in the catalogue of reasons, it wasn't foremost."

Chris asked if the timing of the June 2005 "Strategic Choices" and the Project Phineus presentations jogged Mr. Mudd's memory in terms of Fannie Mae's increased purchases of NTM loans. Mr. Mudd said that "I remember in the conduct of the presentation that a lot of the value from Citi and McKinsey was that it wasn't an internal study – from the outside, they were looking at the market saying what [we could do]. I do not think that their views with respect to the relative risk in mortgage products, or the specific things going on in the mortgage market carried as much weight. Again, the part I remember was that there were areas of the market where we were participating and there were areas within the normal conforming market where they saw us not participating and the conclusion was, 'you can do more within the charter.'"

Mr. Mudd said that Fannie Mae increased its purchases of Alt-A initially, and that "I think over that time, there was a modicum of subprime business, and then [we saw] the development of a suite of affordability products as the housing goals became more stringent."

Chris asked if Mr. Mudd could explain generally what the Company did in terms of altering eligibility requirements as it started increasing its purchase of NTM products. Mr. Mudd said that there were "some differences from the existing box although some of the external parameters like LTV were broadly similar to those within the existing book." He said that the LTV on the book overall stayed fairly constant, but that the LTV on the Alt-A book was somewhat higher than the overall book, reflecting the nature of the product and the vintage.

Chris asked if Fannie Mae also started to buy loans with higher debt-to-income ratios, and Mr. Mudd said that "in general, as affordability became more of a challenge, DTIs went up, but I don't recall the specific products."

Tom Stanton asked if documentation standards were relaxed on NTM products, and Mr. Mudd said that Alt-A generally had more lax underwriting standards than A loans. "The process at the time," he said. "The way I think about is, it's not simply the type of product – it's what does it cost to be there, what do you get for it, and how do you deal with the risk? As we went more broadly [into NTM products], the fees were higher because the loss line would be higher, so we had to charge a higher G fee, and then above and beyond the charter mission, we would purchase incremental mortgage insurance to cover uncertainty and risk."

Model Fee vs. Charged Fee

Chris asked how the Company used its model fee in swap transactions. Mr. Mudd said, "It would be used in terms of offering prices to customers in the securitization business. There were two components - there was the model fee and the charged fee, so the model fee was produced as a result of the pricing model that then became part of the rate sheet which was the subject of conversations with customers. And the rate ultimately agreed to and charged would depend on the mix of business and volume that actually came in. That would be the charged fee."

Mr. Mudd said that early in the decade, there was a relatively high gap between the charge fee and the model fee, and so the Company created a special initiative to get the charge fees up to the level of the model fees. He said that the thrust of the "close the gap" effort was to make it difficult to give away price during negotiations with customers. Mr. Mudd said that he thinks the initiative was largely successful. Chris asked how the NTM products impacted the Company's efforts to "close the gap" between the model fee and the charged fee. Mr. Mudd said that he does not recall how much new products contributed to closing the gap and does not recall the specifics of negotiations regarding price on NTM products.

Tom Stanton asked how long a rate sheet would be used, and Mr. Mudd said that that depended on the agreement with the lender. He said that the Company would not normally change the terms of price negotiations in the middle of a deal, although he said that "there could be material changes, so it wasn't carved in stone, but it was the basis of the customer negotiation. [The rate sheet] wasn't legally binding throughout contract. If you were going to depart from [the rate sheet] that would be the subject of conversation or negotiation."

Chris asked if the Company was charging G fees that were less than the model fee because the market simply wouldn't bear it, and Mr. Mudd said, "that happened sometimes." Chris asked if that was a common occurrence for NTM products, and Mr. Mudd responded, "I know that the model fees and charged fees for Alt-A product was higher than that for the main book, and as I said, [we] carried the additional [mortgage insurance], which should've had an ameliorating affect on the gap."

Chris asked if Mr. Mudd recalled a specific "gap report," and Mr. Mudd said that he did not. "[The gap] would be a typical topic of conversation in A&L meetings," he said.

<u>Fannie Mae's Increase in Purchase and Guarantee of NTM loan products</u>

Tom asked if Fannie Mae used a capital allocation system by business segment when Fannie Mae decided to increase its participation in Alt-A and other risky products. Mr. Mudd replied that "the way you'd get at capital allocation is through the process of pricing the product."

Chris asked if in addition to satisfying customer demands, Fannie Mae increased its participation in NTM products in response to the fairly substantial declines in market share in the 2004-2005 timeframe. Mr. Mudd said, "yes, that was a factor." Chris asked him to elaborate, and Mr. Mudd said, "I don't think that market share per se was certainly what I viewed as a primary metric. But your relative market share with your customers or with the market informs you as to whether you are relevant or not. And obviously, if your market share goes to zero, you don't have a business. And so during this period of time, market share had gone from, as best I recall, the mid 50s down to mid-to-high 20s. And some of the business was being designed to go specifically around Fannie Mae. The question was, is it going around us because of our pricing standards, our cost, the difficulty of doing business with us? Or is it going around us for reasons that we don't mind them us going around us for, which is to say that the business isn't as good. So as in most situations like this, the answer would be a mix of all of these things. We took a broad look at all of the ways we interacted with our customers, and we looked at where the market was, and we gave existential thought to what our role was in the market – are we a quasi-regulator, or are we a commercial enterprise? And the answer to all of those things was that we were a little bit of both."

Tom asked if Fannie Mae was concerned that some companies were providing services from origination all the way through securitization, and Mr. Mudd said, "Yes. And that was burgeoning. It was part of our strategic analysis."

Chris asked Mr. Mudd to elaborate on when the "relevance" issue he described arose. Mr. Mudd said that, "Well, if you're not relevant, you're unprofitable, and you're not serving the mission. And there was danger to profitability. I'm speaking more long-term than in any given quarter or any given year. So this was a real strategic rethinking," he said.

Tom Stanton asked Mr. Mudd to clarify his statement that Fannie Mae was a "quasi-regulator." Mr. Mudd said, "Many of the documents that are used in the mortgage market, whether they are Fannie Mae loans or not, are Fannie Mae documents. If you look in the newspaper for mortgage rates, you see the Fannie rate and the Freddie rate, and maybe a few others. So there's a role there, but I'm not familiar in my commercial career with very many businesses where the supplier – i.e. Fannie Mae - effectively dictates to customers how to do business. Again, the supplier doesn't have to buy it, but again, that was an area where there was tension."

Tom asked how Fannie Mae navigated that tension. He said, "We had on the one hand a responsibility to be a standard-setter and to speak out on practices that gave us pause. But there were also consumers at the higher ends of these emerging markets that would otherwise potentially have qualified for a safer, more affordable Fannie Mae-type product that we had a business and a mission obligation to understand." He continued that, "I guess [that tension] leads you to the question of other of – an easy example in this case would be a loan or a mortgage to a teacher who has 9 months of income but not 12 months of income. Not having 12 amortizing payments is an alternative to the typical or standard Fannie Mae product. So one would think that's bread and butter for the mission would be a school teacher. So the question was, can a product be designed that has 9 months of payments but 12 months of amortization, or so forth." So in Fannie Mae's role as a regulator, Fannie Mae to a certain degree was dictating how to do the business for certain customers." Chris asked if that changed as Wall Street became increasingly involved in mortgage markets and Fannie Mae's market share declined. Mr. Mudd said, "I would attribute it in the first instance to the fact that the agency market was on the wane. Homeownership was going up. Interest rates were going down. The friction in the mortgage system was going down, embodied by ease and simplicity of refinancing into or out of products. So that, combined with burgeoning computer power that enabled investors of all types to invest in mortgages, to buy mortgage related securities and mortgage derivative securities, all of that gave the market and individual homeowners many more choices." He said that there was "More supply, more demand, more competition – more of all of it."

Chris asked if Fannie Mae's cost of funds offset to increased competition. Mr. Mudd said that he "never saw it that way." "We lost deals to other people every day by 2-9 basis points. I saw studies that said that the deposit funding base of banks was possible competition with Fannie Mae rates, so I did not feel in my time that the portfolio provided that. And indeed, as time went by, we concluded that in fact the portfolio was not as good a business as the guarantee business or the multi-family business."

Tom asked what impact the restatement had on Fannie Mae's ability to innovate. Mr. Mudd said, "I wouldn't submit to you that restatement wasn't an enormous amount of work. But we created a parallel and dedicated wing of our organization to get the restatement done with the thought that the rest of business could continue to focus so we would still have a business there when the restatement was done. It's hard to tell if that was successful. The end of restatement was cotemporaneous with start of housing crisis."

Chris asked if customers were saying that Fannie needed to buy more Alt-A or interest only or subprime loans. Mr. Mudd said, "It was not universal, but it was general. It depended on several things – remembering that the world [was changing]. So there was a long era where customers were either Fannie customers or Freddie customers. And the discussions that Mr. Stanton had earlier asked about regarding rates and term sheets - those were enormously long and complicated discussions. Some larger originators had the ability to take both GSEs as their suppliers and bid the business out between them. So there's a chunk of that business that could go back and forth. There's a middle group that were smaller and more focused. So it depends on the mix of business and the type of client that depended on what they wanted us to do."

Chris said that the CRAM reports show that Countrywide was Fannie Mae's biggest customer, and asked what Countrywide was saying about Fannie's acquisitions of NTM products. Mr. Mudd said, "They were the largest prudential customer and the biggest Alt-A customer. They had an interest in us participating and being competitive across the range of products in the market."

Chris asked Mr. Mudd to comment on the New York *Times* October 2008 account of his conversation with Angelo Mozilo. Mr. Mudd said that he was familiar with the article, but that he could not remember the specific meeting, or a conversation with Mr. Mozilo using those words. "I don't remember that conversation happening specifically," he said. "I visited Countrywide and many other customers, and I had many conversations. And a general topic was 'you need to be a broader supplier in order for us to continue to do business with us.' It would not be such a unique topic of conversation that I could [place it specifically]." He continued that, "in the financial market, you don't need to say 'or else.' There are so many other options [for customers] so whether it's explicit or implicit is not the point. Was that a pressure we were dealing with? Yes."

Tom Stanton asked if the consolidation among originators changed the balance of negotiating strength. Mr. Mudd said, "It did to some extent, but sometime mid-decade the larger originators went away from the 100% partnership model and moved into bidding between Freddie and Fannie, so for larger originators, there was a couple of options. They could've already been working with both GSEs. Certainly larger institutions have more volume to put into the discussion."

<u>Affordable Housing Goals</u>

Chris asked if affordable housing goals influenced the decision to move into riskier, NTM product from 2005-2008. Mr. Mudd said, "In the beginning, we presumed that some [riskier products] would [satisfy goals]. To my understanding, as it turned out some of the product was contrary to the goals, some was contributory to specific categories, and some was the same as the balance of the business. Remember that goals are calculated as percentage of the overall book." Chris asked if the Company increased the purchase of NTM specifically because of goals. "I have to say honestly it was a mix. So it was a business decision with a mission component to it," he said.

Chris asked why Fannie Mae increased its purchase and guarantee of NTM product prior to 2005, and Mr. Mudd said "[it was] part of the market, part of the business, you know, to make money." He continued, "Up until the upward inflection of HUD goals when they crossed 50% - when you are such a large component of the market and you say that 50% or less of the business will be at or around the median, well then 50 percent equals 50 percent. So what comes in the door through the natural course of business will tend to match the market, and therefore will tend to meet the goals. When 50% became 57 ultimately, then you have to work harder, pay more attention, and create a preference for those loans. So that's the timeline, if you will."

Chris asked if Mr. Mudd could explain the differing magnitudes of importance for the various reasons Fannie Mae had for increasing its participation in NTM products. "I'm sorry, I can't," he said. "That's what I'm trying to tell you - it's a mix of complicated factors." Chris asked if Fannie Mae ever priced affordable housing goals at a loss, and Mr. Mudd said, "We on occasion priced affordable housing goals below a target of return, but not at an absolute dollar loss that I know of." Chris asked if that is the same as the model fee being less than the charged fee, and Mr. Mudd said, "They're thematically similar. If the gap is negative, that doesn't mean the loan is necessarily being purchased at a loss."

Chris then asked Mr. Mudd to describe day one losses. Mr. Mudd said that he was familiar with it at one point, but that Chris's description of the day one loss – that it relates to the model fee being higher than the fee ultimately charged – was the extent of his recollection.

Chris said that the FCIC has heard that at least in the summer 2006 timeframe, it was common that the model fee would be more than the actual charged fee on NTM products, and asked if that was discussed within the Company, and if it was a significant issue. Mr. Mudd said that he did recall that issue, and that it was discussed in the Company in that timeframe. "We had a debate as the goals increased as to how to think about pricing for those loans and how to think about effectively [creating] a budget for the cost of meeting housing goals," he said. Chris asked if that debate surrounded pricing of affordable housing goal loans only, and Mr. Mudd clarified that it was his recollection that the "debate was about the entire book of business because as in any financial institution, there are going to be parts of the business that aren't priced as well as you'd like them to be, so it was important to look at individual segments, but also at the overall gap versus the single family guarantee book."

Chris asked if it was fair to say that the model fee was supposed to compensate for risk, and Mr. Mudd said yes. Chris then asked if the debate involved the question of whether or not the charged fee was compensating adequately for extra risk, and Mr. Mudd said "yes, that was part of it. The other part was that this product set was new so we did not have as much robust historical data on what were relatively new loan products. So that was a challenge for the modelers. They produced the models with a degree of confidence which is in part based on the data they had – since the products were relatively new, they didn't have as much history and data attached to them," he said.

Chris asked if the concern was that the price charged was not high enough, and Mr. Mudd said yes. Chris then asked if OFHEO ever said that there were problems with Fannie Mae's pricing, and Mr. Mudd replied, "no, not that I recall."

Tom Stanton asked if, going back to the 2005-2007 timeframe the debate over pricing as goals increased included a discussion of how much return the Company sought. Mr. Mudd said yes, and that affordable housing goals would generate less return, but he said, "To my knowledge we didn't price anything to lose money." He continued that, "As housing goals ratcheted up, part of the question became, 'how far do you go to meet the housing goals, when do you say enough is enough and they're not feasible.' So we thought about how to put controls into that."

Chris asked if Fannie Mae went to HUD at any time and said that the housing goals would require Fannie Mae to lose money on loans. Mr. Mudd said, "The Company had an ongoing and open dialogue with HUD at a variety of levels, and we kept them apprised of our progress with respect to housing goals, both through less formal interaction and formal reports." Chris asked if the Company ever went to HUD or OFHEO and said that the housing goals were too high and would require Fannie Mae to make loans that were unprofitable or unsafe. Mr. Mudd said, "We had conversations with HUD where we expressed to them that we thought the goals were too high and would cause us to stretch too much." Tom Stanton asked what the consequences were of stretching too much, and Mr. Mudd replied, "That we would be further down in the credit spectrum than we were comfortable with." Mr. Mudd said that those conversations took place throughout his tenure as CEO. Chris asked if he knew if similar conversations took place before 2005, and Mr. Mudd said, "I know that there were robust conversations about the level of goals, but that's second-hand and in distant memory."

Modeling Capability at Fannie Mae

After a short break, Chris asked if during discussions about pricing new product that did not have a lot of history there was a concern within the Company about the reliability of the model fee. Mr. Mudd said, "I think the best I can say at this point is that there was a huge amount of uncertainty about if the model fee was at the right level or not."

Tom Stanton asked if Fannie Mae ever benchmarked its modeling capabilities against other companies, and Mr. Mudd said, "I believe so, but because the models are proprietary, that would have been effectuated through advisors, and consultants, or with individuals we had hired from other places." Tom asked what his impression was of the relative quality of Fannie Mae's models, and Mr. Mudd said, "I would say it was better than the other institutions I was familiar with."

Chris asked if OFHEO ever expressed concern about its modeling of the G fee with OFHEO. Mr. Mudd replied, "Modeling as a discipline was a matter of pretty frequent conversation between OFHEO and Fannie Mae." Chris asked if OFHEO expressed concerns specifically about the G fees generated from models, and Mr. Mudd said that he did not recall specifically.

Chris asked if Mr. Mudd knew if it was true that over the summer of 2008 the Fed and the OCC helped OFHEO. He said, "I understand now that that's true. I had no direct knowledge at that time," and that he had no direct conversations with the Fed or the OCC during their review.

Chris then read aloud the following portion of the Conservatorship Memo:

> The decisions of the Board of Directors and senior management prior to 2007 to acquire Alt-A loans and other higher risk loan products is a principal contributor to Fannie Mae's current earnings losses and deteriorated financial position.

Chris asked if anyone at OFHEO made statements like that to Mr. Mudd, and Mr. Mudd said "No."

Chris then read aloud another statement from the Conservatorship memo:

> Members of the executive management team made imprudent decisions to increase market share and enter into higher risk products with outdated models and without all the necessary information or reports to evaluate the risks of its decisions. In addition, the Board's and management's decisions in the recent past to purchase or guarantee higher risk mortgage products contributed to the Enterprise's continuing deteriorated financial condition. Senior management and the Board of Directors made these decisions to increase market share, raise revenue, and meet housing goals. However, many of these decisions were unsafe or unsound because they were based on a flawed lending strategy because management failed to price these loans for risk adequately, relaxed underwriting and eligibility standards, such as mortgages that were unwritten without full documentation.

He asked if anyone at OFHEO make those statements to Mr. Mudd, who again said, "No." Chris asked if any regulator besides OFHEO made similar statements to him, and Mr. Mudd said, "not that I recall." Chris asked if anyone generically expressed concerns along those lines. Mr. Mudd said, "I'd say there was a somewhat schizophrenic interaction with the regulator. We would from time to time receive examination criticism or some desultory expression of concern on an issue, but at the same time, for example, there was a period of time when the subprime companies started to melt down the regulator was encouraging us to do more to refinance people out of subprime mortgages. So I guess I'd say we had many, many conversations, and they didn't always have consistent messages."

<u>2007-2008</u>

Chris asked if the Company was asking OFHEO to lower portfolio caps to provide liquidity [in the late 2007-early 2008 timeframe]. Mr. Mudd said yes, and Chris asked if OFHEO was lobbying for Fannie to help homeowners during that time. Mr. Mudd said, "that was one of the things we might do that wasn't something specifically [they would lobby for] – I was using it as an illustration of the [conflicting message]. I thought the notion of refinancing eligible borrows into a safer mortgages made eminent sense."

Tom Stanton showed Mr. Mudd the 2007-2011 Strategy Plan, and Mr. Mudd said that he approved the document. Referencing the document's statement that "Now is the time to take more risk," Tom asked what Mr. Mudd had in mind in terms of the plan to take more risk. Mr. Mudd said, "In the description underneath [the 'take more risk' statement], there's a sentence that says, 'we'll take and managing more credit risk,' so managing risk here is indivisible from taking risk." He explained that the idea was to create a way for Fannie Mae to take a segment of a package of loans that was unattractive to Fannie Mae for some reason, and create a system where Fannie Mae would "take that piece and sell it off to somebody else, insure it, structure it, create some other form of management so we could be responsible to the customer on the front end, but manage the risk on the back end."

Tom asked if Mr. Mudd was comfortable that Fannie Mae could manage the extra risk, and he responded that, "The areas were being developed. Part of what the plan called for was to develop incremental strategies we would need to implement that [overall] strategy." Mr. Mudd clarified that the project he just described was the Risk Transformation Facility, which never got off the ground. "The notion of developing the capability of transforming risk into a form or structure that we were capable of managing dated back several years before the timeframe we're talking about. It was an ongoing initiative to develop those capabilities. [One area] where our risk transformation capability had developed and was principally expressed was through mortgage insurance. One of the transformation capabilities was using mortgage insurance to bid for coverage on loans that we weren't comfortable with, either on a *parri passu* basis or re-insurance basis," he said.

Tom asked if it was Mr. Mudd's sense that mortgage insurance was "stepping up to allow [Fannie] to take more risk. Mr. Mudd said, "In some timeframe MIs became very difficult to bid on, but mid-decade, yes, they did. I would guess that it's sometime when subprime failed that MIs began to pull back, but that's as much as I recall," he said.

Tom asked Mr. Mudd what happened to that risk transformation strategy. Mr. Mudd replied, "I think the risk appetite - we began to curtail that through 07 and all the way through 08 as well. As Fannie Mae, you can't one day say 'we're going to short the market by 2.6 trillion.' You have a responsibility to pull back starting at the more recent layers or products," he said.

Tom asked how long it took Fannie Mae between the time the Company decided to curtail and the time it could actually apply that decision to the market. Mr. Mudd said that the Company had "the authority under certain circumstances to implement" decisions to curtail its activities, but that the Company had "financial/fiduciary/market responsibility to not take actions that would disrupt the market too severely… A big market disruption would ultimately be bad for Fannie Mae, too," he said.

Tom asked Mr. Mudd to explain the extent to which the issue of serving Fannie Mae's customers played into the Company's strategy. Mr. Mudd said, "I don't' think it's that stark. It's like all decisions in business - in no situation in my life has it been more apparent than it was in the circumstances surrounding Fannie Mae - that all the choices had multivariate inputs and potential consequences, so where it may seem to a specialist that there's a simple, red or a black decision, certainly the for the CEO and senior management, the choices are tremendously complex and iterative."

Mr. Mudd said that "for a complicated set of changes, it might be as long as the length of the pipeline - so up to three months." He said that in contrast, "In 2008, in order to implement the changes faster, you may have come across the instigation of a 25 basis point adverse market fee- that could be implemented immediately, it could essentially be applied as an override because of circumstances at the time."

Chris asked when the Company began increasing prices, and tightening eligibility requirements. Mr. Mudd said, "That's occurring starting in mid-07 and going through the remainder of my service at Fannie Mae, because risk indicators were increasing throughout that time period."

Chris asked if those risk indicators were increasing before mid-2007, and Mr. Mudd said, "There were at any given time, even prior to 2007, ups and downs and puts and takes so you had, for example, structural home price declines in the Midwest from beginning of the decade – that's an adverse sign, but it was offset by looking at other various factors in the housing market. So drawing the line from 2000 forward, the easiest mental image I have is a map of the US with appreciation. And going back to when [the map] first came out, you see that it's green from coast to coast. And then through 2006, you see indicators, in 2007 you see some more, and in 2008, the map turns red. So that's just a visual illustration of the risk indicators. We had many, many risk indicators, and they all needed to be taken [into account]."

Chris asked what other indicators Fannie Mae looked at that made it tighten its standards. Mr. Mudd said that early-term defaults, foreclosures, the news, unemployment rates, and internal data and projections all played into the Company's strategy.

Chris asked if it was accurate that Fannie Mae's economist Mr. Berson expressed concerns to the Board as early as 2005 about housing price declines and interest rate increases. Mr. Mudd said, "My recollection is that going back to 2006, I would characterize his take on market as seeing some signs of weakness."

Chris asked if the Company considered tightening up before mid 2007. He said, "I think in the first instance I was grappling with your use of 'tightening up' because the decisions that went back in 2006 were more in the context of not continuing with some of the initiatives that we had started – what do we think about subprime, for example. So in the timeframe of 2006-2007 in combination with some weakness and so forth, we chose not to continue building out that part of the effort." Chris clarified that he was referring to increasing prices and decreasing eligibility in 2007, and Mr. Mudd said that, "obviously, [tightening up the pools] all at once is the moral equivalent of killing the entire mortgage market."

Chris said that data from Fannie Mae indicates that 2006 is the high watermark of purchases of NTM product, and it is also when the Company institutes its "subprime initiative." He asked if Mr. Mudd recalled that the Company initiated a strategy to increase its purchases of subprime backed triple-A PLS. Mr. Mudd said, "Yes, that was part of broader strategy. Because this was a growing and significant part of the market, it became clear to us that there was some number of subprime borrowers who didn't necessarily need to be in a subprime loan and because those loans had attractive goals attributes and attractive pricing, we instituted a plan of getting into the market step-by step and prudently, starting with purchase of PLS, which enabled you to actually see and model the loan data that comes with it, [keeping] an eye to looking at other kinds of investments in that sector."

Chris asked what other motivations the Company had for increasing its purchases of subprime backed PLS, and, Mr. Mudd said that because they were a growing and significant part of the market, that the Company did not buy all of the product (i.e. stayed out of the riskiest assets), because much of it was attractive for goals, and because the NTM market provided a way for the Company to make money. He said, "There's a difference between a subprime loan per se and a predatory loan," and that "there were subprime borrowers from companies that offered subprime loans who if you looked at them seemed to be paying too high a rate or have a loan that had predatory features." Mr. Mudd also said that "We were also being discouraged by some of the major lenders and customers from entering the subprime market, because I think there was some concern there that we would either reduce the borrower pool or put pressure on pricing. So there were many theories and anecdotes about what was going on in a specific market, so we did some research first, which seemed to confirm that some of [those] things were true, and the next step was to buy securities which would give us more insight about the market and the loans, and then we'd go to the next steps, eventually perhaps to buy the loans you describe."

Chris asked Mr. Mudd to clarify his statement that some lenders discouraged the Company from entering into specific markets in light of his earlier comments about customer pressure for Fannie Mae to "widen the box." Mr. Mudd said, "I think it's a little bit is history related. The Alt-A market came out of the A market as an alternative, so it was in some senses a response to either things were doing or not doing. The subprime market had really, to my knowledge, grown out of the consumer credit world and it often operated through separate origination channels with a higher incidence of broker business and so forth, so it had a different history and heritage than the A market."

Chris asked why in the 10-K the Company classifies subprime loans according to loan originator and then also breaks out loans by FICO band. Mr. Mudd said, "There wasn't an industry standard for either category [Alt-A or subprime] and also, they were fairly small categories. Remembering that Fannie Mae isn't an originator, one basis on which you determine the loan classification is the originator. So we disclose the originators, and subsequently because there were so many ideas of the definition, we expanded the disclosure to say 'here are a lot of the common features that people talk about with respect to non-traditional conforming mortgages.'

Tom asked if Countrywide was classified as a subprime or a prime originator, and Mr. Mudd said, "I do not remember – within each larger institution are various entities, and I recall that Countrywide had a Company that was a subprime specialist, so my guess is that's how those loans may have been classified."

Chris asked if Mr. Mudd had any question about the accuracy of the valuation of the PLS book at the end of 2007 (95%), and asked if he recalled any conversations within Fannie Mae about the valuation. Mr. Mudd said that he did not recall those conversations. Chris asked if he recalled the March 2008 *Barron's* article calling into question the validity of Fannie Mae's valuation of its PLS book, and Mr. Mudd said he recalled the article, but that he did not remember any specific action the Company took in response to the article per se. "We were quite comfortable that in response to all inputs, we did our best to follow all the rules to make sure we complied with all the internal or GAAP policies," he said. Chris asked if as CEO Mr. Mudd signed the 10-K and Mr. Mudd said yes, and that he Company had a process of sub-certification and a disclosure committee as well. "There were weekly meetings on all matters of business, but when it came time to certify… the certifications would cascade up [through the organization] and along the way if anyone had a dissent or an issue or a complaint, they could raise that… obviously in parallel to that, you had individual auditors and controllers working through the materials," he said.

Chris asked if he recalled any discussions specifically about PLS valuations. "In the context of closing the books, there was always disc about valuations, and those were always increasingly challenging as we went into 07 and 08 because of the volatility in the market, because of the lack of alternative bids, and in some cases you couldn't get a clear market bid, you'd go out and get a third party valuation service, so there was certainly a fair amount [of work] going into it," he said. Mr. Mudd also said that for some securities, the Company could look at a price on an exchange, and that the process would depend on type and depth of trading on the securities. He said that the Company would not simply reply on market price.

Chris said that *Barron's* reported that if the Company had gone by the ABX, it would have taken another $7 billion mark, and asked if that jogged Mr. Mudd's memory. "Again, I remember the broad context of discussions and the incremental challenges of finding accurate marks, and I do recall a number of inputs taken to determine what the right mark should be," he said.

Chris asked if he recalled if there was a discussion when Fannie Mae was closing out the books about whether or not the Company needed to recognize an OTTI impairment charge on those securities. “Again, the discussion about valuations and where the various positions would be marked were an enormous source of discussion and tension. I don’t recall the ‘*Barron’s* era’ being distinct from other discussions,” he said.

Chris asked if in the context of increasing underwriting standards in mid-2007, the Company looked at SDQs, and Mr. Mudd said yes, that was something the Company would have looked at, and that rising SDQs would have been among the reasons for tightening underwriting standards and eligibility requirements, but that he did not recall specific conversations.

Chris asked if the Company had expected SDQs to increase in mid-2007, and Mr. Mudd said that he expected that they would have risen for a period. Chris asked what inputs went into the Company’s loss forecasting models, and Mr. Mudd said that there was voluminous data from the market and Fannie Mae’s own that were used to project a variety of scenarios. Chris asked if Mr. Mudd recalled if OFHEO found fault with Fannie’s methodologies, and Mr. Mudd said, “no, I don’t recall that.” Chris asked if Mr. Mudd believed that there were problems with the Company’s loss forecasting methodologies, and if they were not accurately predicting future losses. Mr. Mudd said, “No, not until actual experience exceeded the scope of historical experience, which was mid-third quarter 2008.”

Chris said that the FCIC has heard that in the second half of 2007 the Company was projecting tens of billions of additional losses, and Mr. Mudd said, “There were forecasts generated that showed a whole variety of different scenarios so to my recollection each quarter and each year we were giving a forecast for what losses would be expressed in basis points for the coming quarter if not the coming year, and that was the result of all the analysis and all of the scenario production. So there were a variety of scenarios and as we worked through 2007 and home prices went from a projection that they were going to stop appreciating, to they would decrease in certain areas to they would decrease on average across the entire nation. We did a variety of stress tests and scenario plans to ascertain what the possibilities might look like.” Chris asked if he would receive reports with those projections, and Mr. Mudd said yes, that he would receive reports with a wide range of projections, likely on a weekly basis. Chris asked if the reports would indicate the impact of the projected losses on regulatory capital, and Mr. Mudd said, “There’s two parts to the answer: [there would be] capital forecasts for regulatory purposes under different scenarios, and the other aspect, which is important, is even had it been precisely known what the depth would be in housing price decline, the additional variable is the length of time [that housing prices continued to drop].”

Chris asked if Mr. Mudd recalled if there was discussion in the Company of whether or not Fannie had accrued sufficient loan loss reserves. Mr. Mudd said that loan loss reserves were a common topic of discussion, particularly during the validation process in advance of posting the reserves.

Chris asked if Mr. Mudd recalled asking OFHEO in the fall of 2007 to remove the caps on Fannie's portfolio and that Mr. Lockhart initially refused. Mr. Mudd said that he did recall that correspondence in the August/September timeframe. Chris said that Fannie Mae witnesses had indicated to the FCIC that some in the Company saw that period as an opportunity not just to provide liquidity, but also to increase earnings. Mr. Mudd said that he recalled that view expressed in the Company. Chris asked if he shared that view, and Mr. Mudd said that he "recognized the possibility" of increasing earnings in the timeframe and that it "informed [his] viewpoint."

Chris asked how Mr. Mudd balanced the conflicting issues of needing to provide liquidity to the market and needing protect the Company from excess credit risk. Mr. Mudd said that, "I always emphasized that the simplistic view of the mission was that we lent money to underserved markets, but that the more accurate and sophisticated view was that Fannie's mission was to provide liquidity across the housing market. So there was some mission obligation to continue to provide liquidity to the market when it was extracted otherwise. The example I used was September 12, 2001 - no one knew how to price on that day, and I said, not knowing what to do, 'let's price flat from yesterday,' and that resulted in providing some liquidity, and then transactions started to flow. The opportunity to put on a book of business that would be profitable would be important, but at the same time, in no way could you say 'let's do that without caution, prudence and all that.' And that's pricing, risk mitigation, underwriting standards, and all the other risk mitigation attributes," he said.

Tom asked if customer perception of Fannie Mae changed as a result of the Company's actions to boost liquidity in the fall of 2007. Mr. Mudd said yes, that the "tide was coming back the other way… and you saw the share snap back."

Chris then read the following portion of the Conservatorship Memo:

> Despite clear signs in the latter half of 2006 and 2007 of growing problems in the economy, management continued activity in riskier programs and maintained its higher eligibility program for Alt-A loans, without establishing limits on the Enterprise's total Alt-A position. In the latter half of 2007, Fannie Mae finally tightened underwriting and eligibility standards. However, by that time, the earlier unsafe or unsound practices in which the enterprise had engaged caused significant and growing losses to be embedded in the portfolio

Mr. Mudd said that OFHEO did not make similar comments to him.

Chris asked Mr. Mudd if he agreed that despite clear signs in 2006 and 2007 of growing problems in the economy, Fannie Mae continued risky activity without establishing appropriate limits. Mr. Mudd said, "No, I don't think that's accurate. Did we instantaneously making Alt-A ineligible for delivery? No."

Chris asked if it was true that in 2006 and the first half of 2007 nothing was done at Fannie Mae to tighten underwriting standards or eligibility requirements on Alt-A products. Mr. Mudd said that "up through 2006 and into 2007 the pricing and performance characteristics of the Alt-A book were what was expected, and were largely similar to the overall book, and had to my mind some important features – a higher percentage of MI, that they were fixed-rate loans, that the FICOs and LTVs were broadly similar to the larger book. I think that all of those observations went back into 06."

Chris asked what mistakes Mr. Mudd thinks were made at the Company, and if looking back now, he believes that there were clear signs that should have caused the Company to tighten up earlier. Mr. Mudd said, "because the reality kept exceeding the downside, and so going back to the analogy of the map turning red - the speed with which the map turned red not just in home prices, but in liquidity spreads, SDQs – the speed with which the map turned red so far exceeded our ability to make changes and to get in front of it, there was a time in 2008 in retrospect when we never could've gotten ahead of it again."

Chris said that on the one hand, we see and have heard from others that there was an unprecedented decline, but we are also seeing that a lot of people thought the models were quite poor, whether for coming up with G fees or because they were under-pricing risk or generating unrealistic loss forecasting reports. He then read Mr. Mudd the following excerpt from the OCC's "Observations – Allowance Process and Methodology" document:

> Another significant shortcoming at both institutions is the lack of model discipline. Models at both entities are and have been deemed unreliable in the current environment, as evidenced by the level of management adjustments. Yet there is no process in place to ensure that such weaknesses are promptly and appropriately addressed. Policies and procedures should specifically address: model development, documentation, and validation requirements; redevelopment schedules and triggers; and oversight responsibilities, including required certifications and MIS. Models that are no longer deemed accurate should be decommissioned and alternate arrangements made

Chris asked if Mr. Mudd agreed with the OCC's statements. Mr. Mudd said, "No. The models, like any models, are based on inputs, and we took the models and applied, among others, the worst inputs we could find – California in the 90s, Texas oil patch, the Great Depression, for that matter - once the reality was outside the context of anything that could be historically modeled, I suppose the only option was to simply make up a scenario, and that has obvious challenges. If you looked at the entire market, Fannie Mae and Freddie Mac have about 60-65% of loans in the industry and about 30% of the delinquency. Private companies have 35% of total exposures and have [in the range of] 70 percent of the delinquencies. And you've seen the difference between the securities book versus the overall market, and it's not that bad... on an absolute basis, maybe that doesn't matter, though."

Chris said that although Fannie Mae's NTM product did perform better than the overall market, Fannie Mae's capital was much lower. Noting that at least from the time he became Director of OFEHO Mr. Lockhart said that Fannie Mae needed more capital, Chris asked Mr. Mudd if he agreed that Fannie Mae's capital should have been higher than the regulatory minimums. Mr. Mudd said, "Yes, and we did." Chris asked if he thought that Fannie Mae should have had more than the regulatory minimums plus the 30% surplus, and Mr. Mudd said, "I thought it was adequate for the environment in that period. I thought that ultimately, obviously it was inadequate… but from a practical standpoint you can't - we had raised about $14 billion of capital which costs about 8.5%… ultimately, the answer is yes, and I supported throughout the period that the regulators should have capital discretion - but not just discretion to move capital up."

Chris asked if after he became CEO Fannie Mae lobbied to prevent GSE reform from including capital increases, and Mr. Mudd said, "No."

Tom Stanton asked Mr. Mudd to reconcile his comment that the regulator should have discretion to raise or lower capital with an interview Mr. Mudd gave to Steven Sloan at the American Banker in which Mr. Mudd said that capital levels should be hardwired in statute rather than be subject to OFHEO's discretion. Mr. Mudd said that he did not recall the interview specifically, but that, "My intention throughout was that there should be a minimum capital standard set by statute, and based on certain circumstances, the regulator should be able to move it up and down as those circumstances arise, but that absent those circumstances, capital should be at the minimum." He said that "it's simply a matter of math – if the goal is to attract financing into a housing market, if the only direction capital can go is up, eventually it would put you out of the market."

Tom asked if Mr. Mudd thought that the Company could continue to serve its mission if it had capital at bank levels, and Mr. Mudd said, "sure, if it was acceptable from a policy standpoint to put through a huge increase in consumer mortgage rates."

Tom asked how much Fannie Mae lowered mortgage rates. Mr. Mudd said that to answer that, he usually looks at the differential between jumbo and residential rates, which he said is between one and 23 basis points.

Referring again to the American Banker interview, Tom asked if his comments were a plea to maintain capital levels where they were. "My comments were as advertized," he said. "My thought was always that, GSE status aside, if you didn't know about GSE status, you'd see that we were a company competing in the mortgage market. The difference is that many other competitors are one of many institutions that are regulated by the OCC or the FDIC or the OTS, and by virtue of their scope, those regulators have some built-in proclivity to keep the companies they regulate competitive and productive, and they have a wide view across the scope of regulated bodies. It always seemed to me that one of the problems [was that our regulators did not have that] expanded view. Making the regulator part of something that expands its view so there's not this presumed bias [so that it's options are not as stark as] 'do nothing or raise capital,' 'declare Fannie Mae a systemic risk or declare Freddie Mac a systemic risk.'" He said that it is problematic if "the regulatory posture for two companies is subject to change without any of the perspective that comes with a [regulator with a broader scope]." He said that "the regulator was unwilling to express a clear standard about capital, or about the criteria for satisfying the consent order."

Tom asked how capital was allocated, and if people within specific business units knew how much capital backed their divisions. Mr. Mudd replied, "The capital model was built up off of the very book of business itself, and in many cases, it was built off of loan-level data. So your question was anybody looking at it? Yes, I think so. The other part of question about how much capital we needed, I would be happy to agree with you on the point - we could have used more." Mr. Mudd also noted that "we had additional capital above the buffer, too."

Tom asked if there were incentives to keep capital levels low. Mr. Mudd said that "the incentive is to have the right amount of economic capital for the book of business you have, and I think to that point, any financial institution that goes back in 2011 and incorporates the new data set, their model will ask for more capital. Those inputs before were very different from what will be the extreme inputs now."

After a short break, Chris showed Mr. Mudd the chart showing higher risk assets as a percentage of capital,[1] and asked Mr. Mudd if that was a metric he looked at Fannie Mae. He said that "through the CRO's office and the risk policy committee of Board, we looked at the book, and the capital, and we sliced and diced it in several ways and depending upon different scenarios." He said that this was the first time he had seen the data in the format Chris presented, so it would "take some time to put this chart in context." He added that "in a leveraged financial institution, your exposures are going to be larger than your capital."

Chris said that given that Fannie Mae is more thinly capitalized than other financial institutions, and given the credit quality for some of its assets, he was curious if there might be some analysis of the concentrations of risky assets as a percentage of capital. Mr. Mudd said that "to my recollection, subsequent to the time that I got the job and installed a CRO, there was accompanying most initiatives a business plan with conditions and terms and limits and weight points to look at to, among other things, evaluate the risk and the actual versus realized pricing and all of that."

March 19, 2008 Press Release

Chris asked if Mr. Mudd recalled the deal announced in OFHEO's March 19, 2008 press release that would allow the GSEs to provide additional liquidity to the market. Mr. Mudd said that he

[1] Mr. Mudd's counsel, Mr. Wareham, looked quickly at the chart and disputed its accuracy.

recalled the announcement and the discussions leading up to it with OFHEO and Treasury. He said that "the [capital] surcharge was put on, as I recall, when the restatement was announced to cover the uncertainty factor of Fannie Mae operating without current financial statements. And it was after a point in time in 2007 where we had completed the restatement and remediated all 81 items that were part of OFHEO's consent order, and we had met all of our obligations. And it was unclear to us and to the market, and to investors what it would take - what the actual standard was – before the regulator was willing to release the 30%. And at that point in 2007 there was clearly an evaporation of liquidity from private sources, and policy makers were looking around and saw us, and said 'this is what you're supposed to be doing.' There was liquidity that [couldn't] be applied, but I didn't know the terms under which it could be released and OFHEO wasn't being specific. My concern was, and I had expressed it in no uncertain terms, that I didn't intend to have less capital. What I was afraid of, given the history of the relationship between Fannie Mae and OFHEO and the volatility in the market, that some exogenous event would cause us to go one dollar below the cap line and we would end up in another consent order. I think also at this time, there was a beginning of a human cry - the subprime companies were going down and [borrowers] were getting hit by resets. And I couldn't go raise capital because investors would ask, 'well, when will the existing cap override be released.' So it was all boxed up around that. As I recall at a couple points along the way, [Bob] Steel convened all of the parties to explore the issues to get to some kind of resolution."

Chris asked if Mr. Lockhart was against the deal, and Mr. Mudd said, "That was my impression." Chris asked if he knew why, and Mr. Mudd did not answer specifically. "He could go into our building whenever he wanted. We met once a month. There was nothing he told us do to that we said no to. That said, I thought the onus was on us to operate in a spirit of goodwill. However, I think without legislation, Mr. Lockhart having accreted certain powers as a result of consent order was reluctant to give them up." He said that his main concern was that there were no specific, clearly-stated reasons for keeping the surcharge in place, and Mr. Mudd was concerned that a technical violation of the surcharge would result in another consent agreement. He reiterated that he was willing throughout negotiations to raise capital.

Chris asked if he knew that he would have been able to raise capital, and Mr. Mudd said, "I thought we had pretty reasonable access to capital markets," but that the Company did not have any prior commitments set up prior to OFHEO's March 19 announcement.

Chris asked what Mr. Lockhart's view was of the negotiations. "Clearly, he was a believer that the agencies ought to have more capital, but the existence of the cap surplus gave him a lever to negotiate with, I guess you could say."

Chris asked what Mr. Steel's position was. Mr. Mudd said, "You know, I think his general approach was 'both you guys have reasonable positions, can you compromise in the interest of healing up these markets?'" Tom asked if Mr. Steel had specific actions in mind for "healing up the markets." "He didn't have a specific direction of what he wanted done, except that if borrowers could refinance into safer loans, [he'd want us to] do that," Mr. Mudd said.

Chris asked if the deal required Fannie to purchase any securities that it wouldn't otherwise have purchased, and Mr. Mudd said no. Chris asked if there was any understanding between Fannie Mae and Treasury that Fannie Mae would take certain product off of banks' balance sheets, and Mr. Mudd said, "there wasn't any such agreement."

Chris asked Mr. Mudd if he recalled a potential deal referenced in an August 2008 Treasury email which discussed the possibility of Treasury giving $80 billion to Fannie Mae that the Company would use to buy Lehman's CRE assets. Mr. Mudd said that he did not recall any such deal.

Referring back to Mr. Mudd's description of Fannie Mae as a "quasi-regulator," he asked if Fannie Mae ever contemplated a consumer function where it would call on lenders to make certain disclosures about its loans. Mr. Mudd said, "I talked earlier about the approach to subprime, and in order to qualify loans eligible for delivery in subprime, we required due diligence in the origination process; we required that borrowers have access within that lending institution to get a better quality loan; we had limitations on certain other predatory features."

Tom Stanton asked if there was ever concern within the Company about the AAA rating on subprime PLS and asked if Fannie Mae ever tried to "go behind the rating" on a AAA PLS. Mr. Mudd said, "To my recollection, we did a degree of that analysis and we purchased additional insurance on AAA securities, but we did take some actions besides simple, straightforward reliance on letter ratings. I believe an initial analysis was done – it was not a simple reliance on the rating. There was an analysis on PLS and on the underlying loans."

Tom asked if Fannie Mae purchased any CDOs, and Mr. Mudd said that the Company did not buy any to his knowledge, but that he did not recall why.

Tom asked if it would surprise Mr. Mudd that loans originated by Countrywide had twice the default rate as other originators. "That wouldn't shock me, but not much shocks me anymore," he said. Tom asked if Mr. Mudd knew if Countrywide charged Fannie Mae higher prices for its product, and Mr. Mudd said that "of the Fannie Mae customers I'm familiar with, Countrywide was the most execution-oriented, and went to significant steps to build out a number of different executions, so it would no more than anything else surprise me that they found the highest price for whatever securities they were selling." He said that "There were plenty of products that either we said no to or we required higher standards on, and there was a time period [] when I thought it was prudent to price some of the business away from us, effectively."

Chris said that there was a large backlog to be repurchased due to reps and warranties violations and asked Mr. Mudd if that was a problem. Mr. Mudd said, "that was an issue that had to be worked through. There are two categories of put-backs: one set that are clear and obvious. There are others that are less clear and become increasingly difficult to put back. Those are loans that have been current for several months and are economically significant to both parties and become a source of friction, and ultimately an excessively senior person from both sides had to go essentially loan by loan – it's like counting ballots in Florida." He said that in the context of Countrywide's business model – as an organization that was highly reliant on the secondary market – conversations about put-backs were "pretty ordinary-course discussions."

Chris asked if Fannie Mae was able to determine the profitability of its customer relationships, and Mr. Mudd said, "We had analysis of profitability on a customer-by-customer basis, that obviously is a little bit bounded in time" and that he could not say what the profitability was of any customer "in the tsunami of 2008."

Tom asked what procedure Fannie Mae had in place to detect mortgage fraud, particularly with low-doc loans. Mr. Mudd said that "there was several things. There was a national underwriting center in Dallas that does quality control on loans and has some work to do with respect to repurchase requirements. Obviously a loan made fraudulently would immediately be subject to a put-back. Then there were the normal Sarbanes-Oxley fraud measures. We also built out in mid-decade a component of the audit staff that did lender audits and in incidents where we did find fraud, beyond the put-backs there were customers we ceased to do business with." Tom asked if any large customers fell into that category, and Mr. Mudd said that Taylor Bean Whitaker was a large example.

Referencing the July 16-17, 2007 email exchange between Mr. Mudd and Mr. Dallavecchia about potential cuts to the risk management division, Tom asked Mr. Mudd what his thoughts were on the concerns Mr. Dallavecchia expresses in the emails. Mr. Mudd said that Mr. Dallavecchia was upset following a meeting during which staff cuts were discussed because Mr. Dallavecchia thought that the proposed cuts – 16% from risk management – were set in stone. Mr. Mudd said that after it was clarified that the 16% was a starting point and not a final decision, the problem was solved. Mr. Mudd said that "you don't want to go out there and raise capital without tightening your belt, so we set as a base line 16 percent cuts and then it was the intention to have people go back [to their departments] and see what [they] can do, and that will engender the discussion. It applied to everyone in the Company. To do it over again I would've done it face to face – especially in risk management where it was tough to hire people. So I don't think there was any impingement on his ability to build out [risk management] as a result of [the proposed cuts]."

Chris asked if Mr. Dallavecchia's statement in the email that "I have been saying that we are not even close to have proper control processes for credit, market and operational risk" was consistent with what he was telling Mr. Mudd at that time. Mr. Mudd said, "no, it's not entirely consistent." He said that the majority of other conversations the two had were updates on where the Company was on developing structure, process, hiring and reporting in order to build a "world-class CRO." Mr. Mudd said that "we thought JPMorgan was world-class, and

[Dallavecchia's] coming here was in part recognizing that we wanted to build out our organization in a better way."

Chris said that the special exam report comes out in September 2004 and at the time of the email, Mr. Dallavecchia had been with the Company for over one year and wrote that Fannie Mae was still not even close to having adequate processes. Mr. Mudd responded that "The tone of our discussions was much different from the tone of those emails – the tone in the email expressed frustration about the process, but it wasn't typical… I would've said that the Company was continuing to make progress -. we weren't 'not even close.'"

Tom asked Mr. Mudd to comment on the difficulties posed by balancing the interests of shareholders and the mission. Mr. Mudd said, "As you know, it's a peculiar Company. It's private, with a public purpose, with fiduciary responsibility to earn returns for shareholders. It has statutory and foundational responsibility to support a homeownership market, and it was structured in a way to be limited to one asset class in one country in one economic demographic slice. All of those weights could be balanced in an underlying housing market that was robust and liquid and experiencing rising home values. The housing markets stopped growing and then we moved from recession to 10.2% unemployment – no one removed the mandate to balance, and no one gave guidance as to priorities – shareholders, liquidity, or mission. And so the only outcome was 'Yes - do all three of those.' And as I said, if you had 2.5% capital and you have the world turning red in 6 or 8 months the balance goes from – 'yes' to all those things to 'no, you can't do any.' One of the issues raised on my last day of work was that [we wouldn't] be able to meet housing goals and won't be able to keep capital requirements. It wasn't possible for me and it hasn't been possible to make it since."

Chris asked if Mr. Mudd told Treasury that providing liquidity was not good for the Company's financial condition or hurt its ability to fulfill its fiduciary duty to shareholders. "The conversations were exactly what I just said. The Government is either asking or requiring us to do three things [which were] in danger of becoming a null set," he said. "I'm not asking you the Government to solve my problems, but with respect to things within its control, it's helpful to make intentions clear about capital support, the capital surplus, and fate of Company.

Chris asked if anyone from Treasury said that providing liquidity would be at odds with Fannie Mae's best financial interests. Mr. Mudd said, "Not that I recall specifically." Chris asked if he heard that in general, and Mr. Mudd said that, "you know the market needs liquidity. I guess a lot was listening to 'here's what we're seeing in the marketplace,' and then 'here are some suggestions that we Fannie Mae have that would be helpful to our ability to operate in the market – it was a back and forth dialogue. My feeling was that I asked those questions [about what Fannie Mae would need to operate in the market]. Maybe I asked too late, but I don't feel I got an answer until September 6."

Chris asked if from fall of 2007 until September 2008 there was a government recognition of the problems facing Fannie Mae, but after evaluating the priorities determined that liquidity was a higher priority, and Mr. Mudd said that he did not recall conversations like that.

Chris asked what government officials told Mr. Mudd on September 6, and Mr. Mudd said, "Secretary Paulson said that he was not comfortable with quality of Fannie Mae's capital. OFHEO reverses its position from a few months before, and Bernanke says he is comfortable with the decision. Concerns were expressed about our ability to stay above the capital surplus, and our ability to fulfill the housing goals. And there are two meetings about slightly but not really different things,"

Chris asked Mr. Mudd to describe Fannie Mae's relationship with OFHEO. He said, "Over the period of time [when I was CEO], the OFHEO relationship was characterized by building good will and openness. We had been as careful as we could be not to be publicly critical of OFHEO. I had regularly scheduled meetings with directors, etc., we made room and space whenever and wherever they wanted us to, and I would, within the bounds of my fiduciary responsibilities, tell them everything I'd heard from market and the hill, etc. We had received as of the last cap classification and report of examination that things were on the right track, that capital was adequate, and so the chronicling of the situation on the fifth of September was in one sense sort of a departure from what I thought the spirit of the propriety of relationship would be, and inconsistent with what you would consider better regulatory practice to be - like first warning: fix it; second warning: fix it; third warning: you're out of here. Instead, they went from zero to three with no warning in between. I completely believe that within the realm of decisions to make, [conservatorship] was a consideration that the government had to have on the table, and perhaps I'd say in retrospect with how quickly the housing market was falling, I might give a different answer, but at the time... given the opportunity to clarify the government's intentions, to find out where it was coming down on wanting more capital, return, liquidity, or goals – that could have been salutary to the markets. And I did not think in any way it was fair for the government to have been a position of being in the chorus for the Company to add capital, and then to inject itself in that capital structure like that."

Tom asked Mr. Mudd what his sense was of OFHEO/FHFA's competence. Mr. Mudd said, "Developing, but below average."

Chris asked if in Treasury or Fed officials expressed their opinions about OFHEO/FHFA's competence, and Mr. Mudd said, "Yes, [and they were] similar." Chris asked who specifically shared that view, and Mr. Mudd did not provide a name specifically but he said, "so it went all the way back… my principal point of contact at Treasury was the Domestic Undersecretary, so…" He said that his view of OFHEO/FHFA dated from the time he joined Fannie Mae in 2000. Chris asked if Secretary Paulson and Chairman Bernanke expressed a similar view, and Mr. Mudd said, "not that I recall."

Chris asked again what mistakes, if any, Mr. Mudd thinks that he or the Company made. He said, "With the caveat that any financial executive can look at every non-performing loan and say 'well I shouldn't have made that loan,' I would say, I think I should have gone in sooner and said 'how do you want me to balance the scale, because I don't think it can be done anymore. For Fannie Mae, the structure of one business, one country, one market, one asset, with any form of competitive financial leverage, would not be able to sustain an historically deep and fast decline in home prices, doubled up with a broad-scale recession. The inclusion of these years in the models will dictate more capital, however, if you're going to have a private organization like this, it's got to have a return on equity that's competitive with other financial institutions. Another thing is that consumers deserve a plain-language mortgage with simplicity – where they can look at a sheet of paper that explains their mortgage in one page. I think as you look at the growth of the market, and all of the new products, and track [them] back to origination, you will find a much higher incidence coming through the brokerage channels and being unregulated and doing all of that without skin in the game. And so I think that stage was not well set."

Chris asked if Mr. Mudd believed there were mistakes made in the strategy of ratcheting up purchases and guarantees of NTM loan products, and Mr. Mudd said, "I think in prospect then, and at the time, we had a good process and a diligent process, and we had qualified people to deal with it. In retrospect, the mortgage market would've been safer with 20 percent down, 30 year fixed-rate fully-amortizing loans. The tradeoff between how long a monoline mortgage Company could wait for the return of that kind of market was unanswerable at the time."

Chris and Tom then thanked Mr. Mudd for his time and cooperation, and concluded the interview.

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